Internal Revenue Service

memorandum

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Br1:WEWilliams

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to: Manager, Examination Group 1113

from: Chief, Branch No. 1
Associate Chief Counsel (International) CC:INTL:1

subject: [redacted] - Coordination in development of nonpayment case

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This responds to your memorandum dated May 17, 1990, in which you requested our views of the theory that you intend to use in developing this case at the examination level.

The facts are as follows.[1]/ [redacted] is a musical group consisting of [redacted] individuals who are neither citizens nor residents of the U.S. All of the individuals are residents of [redacted], and were present in the U.S. in [redacted] for less than 183 days. [redacted] is an [redacted] corporation that is managed and controlled in [redacted]; the [redacted] performers indirectly own all of the shares of [redacted]. [redacted] enters into two-year employment contracts with each of the [redacted] performers; under each contract, [redacted] has the exclusive right to manage its employee's worldwide public appearance activities. The employment contracts provide for a fixed salary, and, according to taxpayer's counsel, allow the entertainer no right to veto engagements.

[redacted] entered into an agreement with an unrelated Delaware corporation, [redacted], pursuant to which the latter agreed to arrange a tour of [redacted] to [redacted] performances during [redacted]. The agreement required [redacted] to bear all the expenses of the tour and to pay a fixed fee to

[1]/ These facts are taken from taxpayers' counsel's letter dated [redacted]; and from a copy of the Form 1040NR, Nonresident Alien Income Tax Return, filed by one of the [redacted] performers for [redacted].

[redacted] for the services of [redacted]'s employees, plus a contingent amount dependent upon [redacted]'s gross receipts.

Taxpayers' position

Taxpayers argue that all income earned by [redacted] as well as by the [redacted] performers attributable to the U.S. tours is exempt from U.S. tax under the U.S.-[redacted] Income Tax Convention (hereinafter referred to as "the Convention").

1. [redacted] Taxpayers' argument as to exemption from U.S. tax on income earned by [redacted] on the U.S. tour is as follows. Under Article [redacted] of the Convention, [redacted] is a resident of [redacted], because its business is managed and controlled in [redacted]. The term "[redacted] enterprise" is defined in Article [redacted] of the Convention as "an industrial or commercial enterprise or undertaking carried on by a resident of [redacted]." Article [redacted] of the Convention provides that U.S. tax applies to U.S. source industrial or commercial profits of an [redacted] enterprise only if the enterprise is engaged in a trade or business in the U.S. through a permanent establishment. If an [redacted] enterprise is engaged in a trade or business in the U.S. through a permanent establishment, U.S. tax applies to "the entire income of such enterprise from all sources within the United States."

Taxpayers point out that in Rev. Rul. 54-119, 1954-1 C.B. 156, the IRS held that U.S. source income received by a Canadian corporation attributable to the personal appearances in the U.S. of an entertainer constitutes industrial and commercial profits exempt under Article 1 of the 1942 U.S.-Canada Income Tax Treaty, provided the corporation has no permanent establishment in the U.S.[2]/ Therefore, taxpayers conclude that because [redacted] is not engaged in a trade or business in the U.S. through a permanent establishment, the U.S. income of [redacted], attributable to amounts received from [redacted], as payment for the personal services of the [redacted] performers (industrial or commercial

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[2]/ Rev. Rul. 67-321, 1967-2 C.B. 470, holds that for purposes of the prior U.S.-France Income Tax Convention, the production of theatrical shows is considered to be an industrial or like activity and that payments received by a French corporation for the presentation of floor shows and night club revues are industrial or commercial profits and are not compensation for personal services.

profits), is exempt from U.S. tax under Article [redacted] of the Convention.

2. Individual [redacted] performers - Compensation for personal services - Taxpayers argue that the income received by the [redacted] performers, from [redacted], as compensation for their performances in the U.S. is exempt from U.S. tax under Article [redacted] of the Convention. This Article provides that

[redacted]

Royalties from record sales - Taxpayers argue that U.S. source royalties are exempt from U.S. tax under Article [redacted] of the Convention. Article [redacted] of the Convention provides that

[redacted]

Proposed IRS position

Taxpayers' arguments concerning the personal service income received by [redacted] and the compensation received by the [redacted] performers depend on at least the following: First, that [redacted] does not have a U.S. permanent establishment; and second, that the [redacted] performers are employees of [redacted]

Your memorandum states that it is your intent to develop this case on a "substance versus form" basis and to tax the individual performers on the net profits of the U.S. tours in [redacted] and probably in [redacted]. Ms. Regier in your office advised us that she has not refined the basis for her substance over form argument. Also, you have not formulated a position with respect to the royalty income.

Discussion

There are a number of potential arguments that the IRS could make in this case. The defensibility of these arguments depends on what facts are developed to support the arguments. As previously stated, taxpayers' position is that the income received by [redacted] from [redacted] is exempt from U.S. tax under [redacted] of the Convention, because the former does not have a U.S. permanent establishment. If the IRS could establish that [redacted] does, in fact, have a U.S. permanent establishment, the income would be subject to U.S. tax.

Alternatively, whether or not [redacted] has a U.S. permanent establishment, the IRS could argue that the amounts paid to [redacted] by [redacted] were income to the [redacted] performers and not to [redacted] If this could be established, the income would be personal service income to the performers and not exempt from U.S. tax under Article [redacted] of the Convention, because the services would not have been "performed for or on behalf of a person resident in [redacted]."

In order to argue that the income from a U.S. tour is income of the [redacted] performers and not of [redacted], the IRS would need to establish one or more of the following:

1. The [redacted] performers were not employees of [redacted] but were rather independent contractors;

2. [redacted] was a sham and is to be disregarded for federal tax purposes; or

3. The [redacted] performers made an assignment of their income to [redacted] and the assignment will not be recognized for federal tax purposes. That is, the income was constructively received by the performers who had assigned it to [redacted]

[redacted] - U.S. permanent establishment issue

The term "permanent establishment" is defined in Article [redacted] of the Convention and includes the following:

[redacted]

[redacted]

We recognize that the IRS concluded in Rev. Rul. 56-165, 1956-1 C.B. 849, that a Swiss resident, present in the U.S. to demonstrate and sell logging equipment, has a U.S. permanent establishment for purposes of the U.S.-Switzerland Income Tax Convention, even though the individual had no warehouse or other type of building from which to work. The ruling states that the salesman took orders; that the equipment was necessarily demonstrated in forests; and indicates that a warehouse would be superfluous to the sales operation. A critical fact in the revenue ruling, in our view, is that the sales and demonstration activities were expected to continue for two years. In contrast, in this case, the [redacted] tour extended only from [redacted] to [redacted]. However, if [redacted] made two or three month tours in the U.S. two or three times each year, you might consider making an argument similar to the one made by the IRS in Rev. Rul. 56-165.[3]/

As to basing the finding of a permanent establishment on an agency relationship, it is our view that the distinction between agents that may or may not constitute a permanent establishment of a foreign enterprise depends on whether the agent is dependent or independent. This distinction is explicit in later treaties to which the U.S. is a party. See, e.g., Article 5(4) and (5) of the U.S.-U.K. Income Tax Convention, brought into force March 25, 1980.

The distinction between dependent and independent agents for purposes of a permanent establishment determination is also clear in Article 5(5) and (6) of the OECD Model Double Taxation Convention On Income and On Capital. The Commentary to paragraphs (5) (dependent agents) of Article 5 of the OECD Model contains the following:

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[3]/ An attorney in another branch in this Division is working on an audit checklist to be used in making permanent establishment determinations. We have requested a copy of the checklist as soon as it is finished, and we will forward a copy to you as soon as we receive it.

> It is generally accepted principle that an enterprise should be treated as having a permanent establishment in a State if there is under certain conditions a person acting for it, even though the enterprise may not have a fixed place of business in that State .... This provision intends to give that State the right to tax in such cases.
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> * * *
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> Persons whose activities may create a permanent establishment for the enterprise are so-called dependent agents i.e. persons, whether employees or not, who are not independent agents falling under paragraph 6. Such persons may be either individuals or companies.... [P]aragraph 5 [dependent agents] proceeds on the basis that only persons having the authority to conclude contracts can lead to a permanent establishment for the enterprise maintaining them....
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> The authority to conclude contracts must cover contracts relating to operations which constitute the business proper of the enterprise.... Moreover the authority has to be habitually exercised in the other State; whether or not this is the case should be determined on the basis of the commercial realities of the situation. A person who is authorised to negotiate all elements and details of a contract in a way binding on the enterprise can be said to exercise this authority ..., even if the contract is signed by another person in the State in which the enterprise is situated....

However, with respect to independent agents, dealt with in paragraph (6) of Article 5, the Commentary states that

> [w]here an enterprise of a Contracting State carries on business dealings through a broker, general commission agent or any other agent of an independent status, it cannot be taxed in the other Contracting State in respect of those dealings if the agent is acting in the ordinary course of his business ....
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> * * *
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> A person will come within the scope of paragraph 6- i.e. he will not constitute a permanent establishment of the enterprise on whose behalf he acts-only if
>
> a) he is independent of the enterprise both legally and economically, and

b) he acts in the ordinary course of this business when acting on behalf of the enterprise.

* * *

Where the person's commercial activities for the enterprise are subject to detailed instructions or to comprehensive control by it, such person cannot be regarded as independent of the enterprise.

Resolution of the question of whether [redacted] is a dependent or an independent agent of [redacted] will depend on the relationship between the two companies. The contract pursuant to which the former arranged U.S. performances for the latter will be important and should be carefully examined. However, if [redacted] is a general booking agent for a number of bands, performers, etc. and [redacted] is but one of its many clients, it is likely that [redacted] is an independent agent and will not serve as a basis to argue under Article [redacted] that [redacted] has a U.S. permanent establishment. However, we recommend that you explore this issue during the examination.

[redacted] Performers

Whether or not the IRS decides to take the position that [redacted] has a U.S. permanent establishment, the facts may support an alternative argument that the income from the U.S. tours should be treated as being received by the [redacted] performers and not by [redacted] As previously stated, the alternative argument could be based on one or more of the following theories:

1. The [redacted] performers were independent contractors and not employees of [redacted]

An argument that the [redacted] performers were independent contractors and not employees of [redacted] would require a factual analysis of the relationship of the performers to [redacted] It will be important to analyze the employment contracts between [redacted] and the individual performers and the agreement between [redacted] and [redacted]

As explained in Rev. Rul. 74-330, 1974-2 C.B. 280, and Rev. Rul. 74-331, 1974-2 C.B. 282, the employee versus independent contractor question, in the context of this case, is a factual issue. Rev. Rul. 74-330 considers four situations involving a U.K. corporation (UKC) and an entertainer (E). The ruling provides that

> important factors which indicate an employer-employee relationship between E and UKC are as follows: E is subject to the control and direction of UKC as to time, place, and manner of performance; E has an exclusive personal service contract of substantial duration; E is furthering the regular business of UKC; E may not veto engagements arranged by UKC; UKC is responsible for furnishing E with a place of performance, appropriate costumes, make-up, scripts, musical accompaniment, or the like; E's salary is not based on the net profits derived in respect of his performances; and UKC bears customary business risks in connection with furnishing E's services. Of the foregoing factors, the right to control E in the performance of his services is the most important. An employment relationship does not exist where UKC merely acts as E's agent. [Citations omitted.]

The same factors are listed in a double loan out arrangement described in Rev. Rul. 74-331, 1974-2 C.B. 282.

While taxpayers argue that [redacted] determined the time and place that [redacted] performed and that the performers had no control over the corporation's decisions, the performers were the corporation's sole shareholders and employees. If all contracts between [redacted] and [redacted] were negotiated and signed by one or more of the performers and one or more of the performers approved performance dates on behalf of [redacted], we think that the IRS would have an argument that the performers were not in substance employees of the corporation.

2. [redacted] is a sham

Under this argument, [redacted] would be ignored for federal tax purposes and the income from [redacted] would be treated as having been paid directly to the [redacted] performers.

A sham argument in contexts similar to the one in this case is suggested in Rev. Rul. 74-330, 1974-2 C.B. 278; and Rev. Rul. 74-331, 1974-2 C.B. 282. For determining whether a corporation is a sham, both revenue rulings refer to Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 439 (1943), in which the Supreme Court held that "so long as [its] purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity."

In Keller, Inc. v. Commissioner, 77 T.C. 1014 (1981), aff'g 723 F.2d 58 (1983), discussed above in connection with

section 482, the IRS argued that the income attributable to the doctor's personal services was earned by the doctor and not by his corporate employer and sought to tax the income to the doctor under either section 61 or section 482; the IRS did not challenge the separate existence of the corporation. However, the Tax Court treated the IRS's position as an indirect challenge to the corporate existence. In this regard, the court stated, at page 1031, that

> [t]he policy favoring the recognition of corporations as entities independent of their shareholders requires that we not ignore the corporate form so long as the corporation actually conducts business. Moline Properties ....

We recognize, however, that the Government prevailed on a sham argument in United States v. Johansson, 62-1 U.S.T.C. 82,197 (S.D. Fla. 1961). In Johansson, a Swiss corporation, Scanart, GmbH, contracted with Floyd Patterson, the U.S. heavyweight boxing champion, for a prize fight between Scanart's sole employee, Johansson, and Patterson. The IRS argued that Scanart was a sham and, thus, that the income attributable to the fight and to certain promotional activities was received directly by Johansson.[4]/ In holding that Scanart was a sham, the court found that Scanart had no legitimate business purpose and was formed temporarily to divert Johansson's U.S. source income from a taxable to a nontaxable recipient; that Johansson retained complete control over the proceeds from the fight and from the promotional activities; and that he had no personal or business ties to Switzerland where the purported corporation allegedly carried on business.

It is our view that Johansson is a unique case and that the IRS will only infrequently prevail on a theory that a corporation does not exist for tax purposes. We think that in most instances a business purpose and some business activity will be present to support separate corporate existence.

Furthermore, based on the information supplied by the taxpayers in this case, [redacted] was not formed as a temporary vehicle to divert income from one or a few performances as was true of Scanart; and [redacted] is

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[4]/ If Scanart was recognized for federal tax purposes, the income from the fight and from the promotional activities would have been exempt from U.S. tax under the U.S.-Switzerland Income Tax Convention, under a theory similar to the one used by [redacted] and the [redacted] performers in this case.

organized in [redacted], the country of residence of its shareholder/employees, unlike Scanart, a Swiss corporation, whose shareholder/employee was a citizen and permanent resident of Sweden.

3. Assignment of income

The assignment of income argument originated in Lucas v. Earl, 281 U.S. 111 (1930), and is essentially the theory that under section 61, income is to be taxed to the one that earned it. In Lucas, a husband and wife entered into a contract declaring all property received by them to be taken as joint tenants. The husband earned and received a salary and certain fees, and the Supreme Court upheld the IRS's position that one-half of this income could not be pre-assigned to another taxpayer (i.e., his wife). In Roubik v. Commissioner, 53 T.C. 365, 379 (1969), the issue was whether income was to be taxed to a personal service corporation or to its sole employee who generated the income. The court phrased the issue as follows:

> In the case of a corporation which provides personal services for a fee, income is "earned" by the corporation or by the person who actually performs the services, whoever has the "ultimate direction and control over the earning of ... [the] compensation." [Citation omitted.]

However, when it is a question of raising an assignment of income argument to allocate income from a corporation to the corporate employee whose services earned the income, some of the same tension develops as with an attempt to sham a corporation. See Foglesong v. Commissioner, 621 F.2d 865 (7th Cir. 1980). That is, a corporation's income is earned through the efforts of its employees, and, except in cases where the corporation has been virtually ignored in the course of the employee's rendition of services, income earned by an employee will usually be treated as earned by his corporate employer; and an assignment of income argument will fail. Therefore, it will be important for the IRS to develop facts indicating that the performers made all corporate decisions and were not in substance employees.

It is our view that the same factors relevant to whether the [redacted] performers were employees of [redacted], or were independent contractors, are relevant in determining whether the performers assigned their income to the corporation. We think that if the performers were the sole shareholders and "employees" of [redacted], taxpayers will have difficulty in establishing that, in fact, they were employees.

I.R.C. § 482

We do not believe that a theory under section 482 would be of significant benefit to the IRS in this case, because the theory would not prevent the income of the performers from passing through [redacted] However, if the IRS succeeds in establishing that the performers are independent contractors and not employees of [redacted] or in shamming [redacted], section 482 could serve the limited purpose of providing a theory for moving the income from the corporation to the individuals. While section 61 should be adequate authority to attribute the income to the individuals, some courts have preferred to rely on section 482 under these circumstances. See, e.g., Rubin v. Commissioner, 429 F.2d 650 (2d Cir. 1970); remd'g 51 T.C. 251 (1968); decision on rem'd 56 T.C. 1155 (1971); aff'd per curiam 460 F.2d 1216 (2d Cir. 1972).

Section 482 authorizes the IRS to distribute, apportion, or allocate gross income in order to clearly reflect income in an appropriate case where two or more organizations, trades, or businesses are controlled by the same interest. Section 482 has been applied to allocate income between a corporation and its shareholder or employee. See, e.g., Borge v. Commissioner, 405 F.2d 673 (2d Cir. 1968), aff'g T.C. Memo. 1967-173, cert. denied 395 U.S. 933 (1969); and Rubin v. Commissioner, 56 T.C. 1155 (1971), aff'd per curiam 460 F.2d 1216 (2d Cir. 1972).

Section 482 is a valuation/pricing statute - in this case, it would be used to value the services of the [redacted] performers. That is, if the compensation received by the performers as employees of [redacted] is substantially less than what the individuals would have received as independent contractors, an allocation of income may be appropriate. Section 482 is not, however, authority for restructuring the manner in which a taxpayer has arranged his affairs. For example, in Borge, supra, the courts permitted allocation of income from a corporation to its employee without shamming the corporation. Therefore, section 482 will not support an argument that [redacted] should be ignored for tax purposes. Therefore, section 482 is not an independent basis upon which the IRS could assert a deficiency against the performers. However, section 482 may be cited as authority, with section 61, for the income being taxed to the performers, if the IRS establishes that the performers are not employees of [redacted] or that the corporation is a sham.

Royalties from record sales

Taxpayers argue that the royalties from U.S. record sales, that are paid to [redacted], are exempt from U.S. tax under Article [redacted] of the Convention. Article [redacted] exempts from U.S. tax royalties received by a resident of [redacted]

[redacted]

Article [redacted] of the Convention states that for purposes of Article [redacted]

[redacted]

Thus, a U.S. permanent establishment is a prerequisite to taxation of U.S. source royalties paid to a resident of [redacted]. In this case, potential arguments could be that either [redacted] or the [redacted] performers have a U.S. permanent establishment by virtue of the activities that [redacted] undertakes on their behalf in the U.S. This issue has been previously discussed in connection with whether [redacted] has a U.S. permanent establishment.

Conclusions

We have not made any recommendations as to precise positions that the IRS should take, or the arguments that the IRS should make, in this case. Decisions on these matters will turn on the facts that are developed during the examination. We have only suggested some possible theories that you might keep in mind during the audit. If any questions or issues arise during the examination, we will be glad to provide assistance at your request.

If you have any questions or if we can be of further help, please call Ed Williams at 287-4851.

GEORGE M. SELLINGER